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Fragile? Yes, but ready to move on

 By Mark Zandi, June 29, 2014

You might have been dismayed by reports last week that the nation's gross domestic product fell nearly 3 percent in the first quarter of this year. Such declines, in the value of all the goods and services we produce, typically occur only in the depths of a recession.

But don't despair. While the economy is still fragile, it is growing, and the next recession is a long way off.

Behind the GDP decline was a bad brew of one-off factors. Remember how tough last winter was? Businesses won't soon forget, as many will never recoup the sales lost to the polar vortex.

Also, the federal emergency unemployment insurance program, which provided benefits to those who were out of work for so long that they ran out of state benefits, expired at the start of the year. Congress declined to help these unfortunate workers and their families, who thus had no choice but to cut back their spending.

A third important factor was a bit more arcane: U.S. businesses added aggressively to their inventories late last year and then pulled back at the start of 2014 to compensate. Firms have since done a good job of balancing inventories - the volume of products on store shelves, in dealer showrooms, and in warehouses - with consumer demand.

Another reason GDP looked bad in the first quarter is that the federal statisticians who tally it have had difficulty gauging the effects of Obamacare on health-care spending. The bean-counters thought the formerly uninsured would increase demand for health care quickly. Now it looks as if this will happen more gradually.

While all these factors depressed growth data early in the year, they have largely faded since. Weather this spring was about normal; unemployed workers have cut back as much as they are going to; inventories are in good shape; and Obamacare is helping more of the previously uninsured obtain health care. Economic growth rebounded sharply in the second quarter, and it appears to be gathering strength.

Investors shrugged off the bad first-quarter GDP number; stock prices continue to flirt with all-time highs. Initial public offerings are surging, adding more fast-growing companies to the stock market. Bond investors continue to eagerly buy the debt of riskier companies, which they wouldn't touch if they thought the economy was in trouble.

More important, businesses remain sanguine. Layoffs have never been lower, and hiring is picking up. Job gains are increasingly broad-based across industries and regions. Companies of all sizes are adding to payrolls, and while lots of low-wage jobs are being created, for the first time since the recession, there are more middle- and high-wage jobs, too.

Businesses appear to be nearing a *Field of Dreams* moment, realizing that they can no longer increase profits merely by cutting costs. They need to take chances - introducing new products, expanding into new markets, entering new partnerships, and funding bold new ideas.

Recessions leave businesses predictably reluctant to take such risks. This was especially true of the Great Recession, during which many firms faced near-death experiences. Their anxiety was heightened by a string of macroeconomic threats, including a potential crack-up of the eurozone and Congress' flirtation with a default on U.S. debt. The massive regulatory changes that accompanied Obamacare and the Dodd-Frank financial reforms also left many businesses unable to shake a bunker mentality.

Until now.

The recession is five years in the rearview mirror and doesn't seem nearly as scary. The eurozone remains intact, and the threat of a U.S. default has faded. Businesses are still adjusting to health-care and financial reform, but most are well on their way.

Surveys of business confidence reflect that. The National Federation of Independent Business' monthly poll of smaller firms suggests the mood is more upbeat than it has been since before the recession. Only confident businesses post new job openings, which the latest NFIB survey found to be as plentiful as they've been since the best of times during the last recovery.

My own Moody's Analytics survey of larger companies, which I've been doing for more than a decade, has never been stronger. Astoundingly, more than three-quarters of the businesses surveyed say they think conditions will be even better six months from now.

All indications are that firms are set to take the plunge and "build it," believing that if they do, customers will come. As long as consumers don't lose heart, businesses will be rewarded for their risk-taking, hiring and investment will improve, and the economy will kick into that higher gear we've all been waiting for.

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